MNC Stocks – Defensive Value picks

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Multinational companies (MNC) have historically enjoyed premium valuations to their Indian counterparts. This is primarily due to their financial strength, strong parentage, good cash reserves, low debt exposure, asset light model and technological proficiency. Professional management, transparency in operations and good working capital management aids maintain a safe image. Healthy RONW / ROCE, good dividend distribution policies and clean financials attract investors. Most of these companies are debt free and cash rich. Prudent management ensures aset reallocation whenever required and MNCs don't tend to hold on to businesses/cash only for pride.

While MNCs are as susceptible to market conditions as their Indian counterparts are, they have greater staying power in adverse circumstances due to the sheer size and backing of the parent companies. Again, due to the parent companies, they have greater access to export markets (though, at times, access to different countries is decided by the parent on other parameters). The parent companies are often their customers too. Thus, overall, the general perception is that MNCs in general offer better value to shareholders.

For years, MNCs operated in India through subsidiaries. They were forced to list on Indian stock exchanges in the late 70s due to the enforcement of the Foreign Exchange Regulation Act. Over the years, litigation between MNCs and the state continued over issues like parent company holdings, royalty paid to the parent, minority shareholder interests and so on. Previously, MNCs were happy holding 51% stake in their listed Indian subsidiaries but over the past few years it has been noticed that they have increased their shareholding either through creeping acquisitions or open offers. Nestle, Unilever, Siemens, ABB and Vodafone are some such companies that fall under this category.

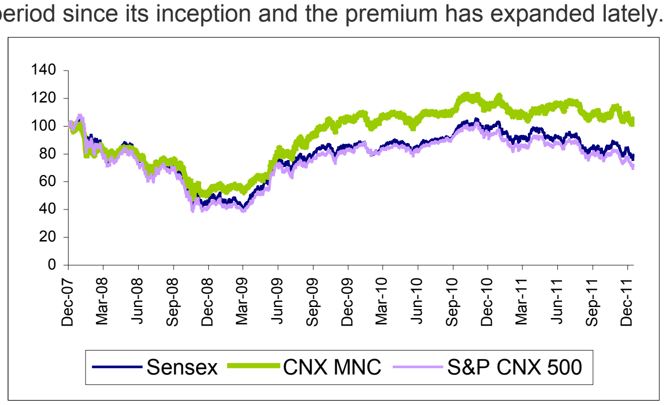
The government's introduction of minimum 25% float in any listed company could demoralize several MNCs from remaining listed on the Indian bourses. Companies with over 75% stake could make open offers to acquire the remaining shares and thereafter, delist and in some rare cases, divest shares through negotiated deals or public offers to offload the excess over 75% held by them.

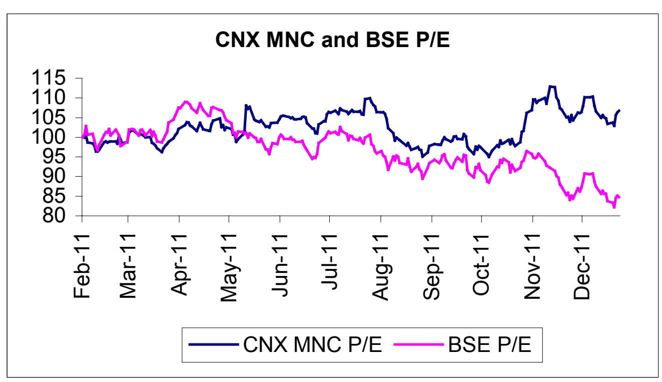
The fact that the parents of Indian MNCs quote at a much lower P/E (except in a few exceptional cases like Glaxo, Hitachi and Ingersoll) than their listed subsidies in India reflects two things – higher growth potential in India and lack of other investible high quality stocks in India.

	Parent MNC P/E (trailing 12 months)	Indian subsidiary P/E (trailing 12 months)
Abbott	19.3	32.6
Glaxosmithkline	45.1	29.1
Hitachi	150.1	22.6
Ingersoll-Rand	34.6	22.4
Kennametal	11.3	18.2
Marui Suzuki	5.0	15.5
P&G	16.9	37.8
Pfizer	15.1	20.5
Siemens	10.4	33.4
Unilever	16.7	32.3

(Source: Yahoo Finance, Capitaline, HDFC Sec Research)

As a result of the several factors listed above, MNC stocks are better placed in poor market conditions. The chart below shows the performance of the CNX MNC index vs that of the Sensex and the S&P CNX500. While MNC stocks fell as well in the 2008-2009 global economic crisis, it is evident the fall was subdued. In the upmove too, MNC stocks rose more than the general market. This trend gives investors the comfort of lower losses and higher gains, a win-win situation. It is evident that investors like investing in MNC stocks despite their higher valuations. The second chart below shows that the CNX MNC has traded at a premium to the Sensex for most of the period since its inception and the premium has expanded lately.





(Source: NAV India, Capitaline, HDFC Sec Research)

In the recent market downfall even this category of stocks was not spared. This fall is reflected in the NAV of different MNC focused funds like the Birla MNC and UTI MNC. These funds have fallen by 11% and 3% respectively in the past year. This compares with the 21% fall in the diversified equity category. However, returns remain positive over a 3 year and 5 year period indicating long-term stability and growth potential.

MNC stocks have seen a part of their premium valuations shaved off over the past one year and thus offer a good entry point for the 'wary investor'. These stocks are a good fit for those investors who want to invest in 'value stocks' and are averse to capital erosion. In the short term, these investors could benefit from decent dividend yields and in the medium term from potential capital appreciation. MNC stocks could be considered similar to defensive stocks in the current market scenario. When the broader economy starts to recover these stocks could offer decent returns. These stocks may not grow very rapidly in terms of topline and bottomline, but could offer returns in excess of 12%+ p.a. over the medium term.

Potential delisting of some of these could be another trigger for such companies. In the 2001-2003 downturn of the equity market, more than 10 MNC companies including Otis, Cadbury, Reckitt Benckiser, Carrier Aircon took advantage of the low valuations and delisted their equity shares from the Indian markets. Later, several other companies such as Avery, Bosch Chassis, Rayban, Sandvik, Syngenta, Wartsila and Yokogawa also delisted. It has been noted that European companies tend to be the most active in delisting their Indian subsidiaries followed by American companies. Asian owned (including Japanese) companies usually do not delist frequently.

A weak equity market and low current valuations provide the parents of these companies with an opportunity to increase their stake at a much cheaper price although their offer price will have to be at a premium to the current prices. Some companies such as Esab, Ingersoll, Blue Dart, Disa made an attempt to delist their shares but did not accept the hefty prices at which shares were offered.

There are a few concerns with respect to investing in MNC stocks. Firstly, some shareholder inimical practices (including floating 100% subsidiaries and routing growth business segments through them) have surfaced in the past and affected valuation levels. Next, the universe of MNC stocks is also shrinking fast with global parents buying out stakes held by others and opting for delisting the stock. The tendency to make gloomy forecasts of the company's performance, informed trading and even deliberately depressing the performance have in case of some companies become an integral part of the MNC delisting process. Next, continued indifference of the parent in terms of product introduction, business and growth, corporate governance issues are some more issues that could surface. Lastly, the financial and operational condition of some MNC parents may not be strong enough after 2 rounds of slowdown.

Overall, at this point the market is offering attractive entry levels for these stocks. Improvement in the broader economy and the possibility of delisting could trigger an upmove in these stocks. Other reasons for the re-rating of the stock include a takeover of the parent company in the present uncertain global scenario, which in turn would trigger a compulsorily open offer in the Indian markets, announcement of special dividends as many of these companies are cash rich and novel product introduction from the parent's portfolio into the Indian market.

While the market environment is sure to tempt many to keep away from investing, that need not be the strategy for long-term investors. Even if the wait could prove long, investors can look at building their long-term portfolio gradually at prices from current to about 10-20% lower in each scrip's price. The investment strategy needs to be staggered, as the worst may not be over yet for the markets.

Qualitative risks of management honesty and commitment remain and hence one needs to review the investments at periodic intervals. While this risk can be dealt with by adequate diversification, the need to review investments cannot be overemphasized.

We have attempted to shortlist MNC companies that are based on Graham and Buffet's style of investing. For the sake of analysis, we have considered only those companies as MNCs where direct foreign promoter holding is 20% and above. However, we have not included all those companies which can be technically dubbed MNCs, as they have a majority direct foreign holding, but are not MNCs in the true sense of the word as they have NRI promoter(s). Hence, companies like Sesa Goa do not feature on our list. Our time frame for the study is 3 years. The parameters that we have chosen include:

1. Price to Earnings below the highest of the lowest 10 percentile of positive P/E companies – (P/E works out to 4.33)
2. Price to Book Value below the highest of the lowest 10 percentile of positive P/BV companies – (P/BV works out to 0.45)
3. Dividend Yield above the lowest of the highest 10 percentile – ie all dividend yields > 5%
4. Adjusted BV > Price; where, adjusted BV = Net Current Assets + Marketable investments – Total Debt – Miscelleneous expenses not written off
5. Enterprise Value to EBITDA below the highest of the lowest 10 percentile of positive EV/EBITDA companies – (EV/EBITDA works out to 3.65)
6. Pledged shares criteria depending on the % of promoter shares pledged
7. Net Current Assets/Sales below the highest of the lowest 50 percentile of positive NCA/Sales companies – (NCA/Sales works out to 0.27)
8. Debt/Equity below the highest of the lowest 50 percentile of the positive D/E companies – (D/E works out to 0.13)
9. Other criteria include grwoth in YoT half yearly sales, EBITDA and PAT and an increase in Interest Coverage for the half year YoY

The analysis is based on the reported numbers for FY09 to FY11 (for yearly analysis) and H1FY11 to H1FY12 (for half yearly analysis).

We have given weightages to the above parameters and shortlisted the companies with the highest scores. Some exceptions (in excluding some companies) have been made based on our perception about the company, its performance and likelihood of going in for stake hike/delisting.

The following are companies (in alphabetical order) we have short-listed from the group of MNC stocks. Among these, the companies that have 75% or more foreign promoter holding could experience buybacks by the parent in order to delist.

Co_Name	Industry	CMP as on 23/12/11	P/E	P/BV	Div. Yield	D/E	Adj. BV	EV / EBITDA	Gr. In sales H1FY12 vs H1FY11	Gr. In EBITDA H1FY12 vs H1FY11	Gr. In PAT H1FY12 vs H1FY11	Foreign Prom. Holding (%)
Agro Tech Foods.	Solvent Extraction	357.1	42.0	4.9	0.5%	0.0	43.64	17.02	0.0%	15.0%	15.0%	48.1*
Akzo Nobel	Paints / Varnishes	757.3	22.9	2.6	2.4%	0.0	255.24	15.13	22.6%	5.0%	17.2%	56.4
Areva T&D	Electric Equipment	154.6	19.8	3.7	1.2%	0.9	4.69	13.33	19.6%	27.0%	54.1%	73.4
Bayer Crop Sci.	Pesticides / Agrochemicals	695.1	20.6	4.1	0.6%	0.2	77.80	11.51	12.4%	14.6%	26.4%	69.5
Bosch	Auto Ancillaries	6641.1	24.3	5.1	0.6%	0.1	1019.44	13.51	26.6%	23.1%	34.2%	71.2
Castrol India	Lubricants	410.9	20.7	18.4	3.7%	0.0	15.35	15.04	10.2%	1.4%	4.3%	71.0
Clariant Chemica	Chemicals	578.6	13.2	4.2	5.2%	0.0	74.30	4.94	1.2%	197.7%	-1.3%	63.4
Disa India	Engineering	1460.1	14.6	4.0	0.0%	0.0	282.25	5.92	50.8%	15.5%	15.3%	74.3
Eimco Elecon(I)	Engineering	152.2	6.7	0.6	2.6%	0.0	199.34	3.29	-16.7%	21.3%	-32.5%	25.1
Goodricke Group	Tea	109.0	5.2	1.6	4.6%	0.0	29.40	3.68	25.6%	42.2%	35.5%	74.0
Grindwell Norton	Abrasives and Grinding Wheels	209.6	13.8	2.9	2.9%	0.1	26.15	7.76	18.0%	20.4%	24.0%	51.3
India Nipp.Elec.	Auto Ancillaries	151.3	5.7	0.7	6.3%	0.0	124.32	4.2	10.3%	7.7%	6.2%	20.5
Ineos ABS (India	Petrochemicals	591.8	14.9	3.1	0.7%	0.0	118.03	8.47	17.7%	8.8%	6.7%	83.3
ITD Cem	Construction - Civil / Turnkey	118.6	14.9	0.4	1.3%	1.5	116.43	4.8	25.3%	8.6%	68.2%	69.6
Kansai Nerolac	Paints / Varnishes	866.0	25.0	5.1	1.2%	0.1	96.67	12.76	19.8%	10.4%	12.1%	69.3
Kennametal India	Machine Tools - Tungsten carbide	669.9	16.7	5.0	5.2%	0.0	78.60	10.69	35.5%	56.9%	72.5%	88.2
KSB Pumps	Pumps	147.0	4.4	0.6	3.4%	0.0	112.32	8	22.1%	-23.9%	-29.6%	40.5
Paper Products	Packaging	63.2	11.1	1.4	3.5%	0.1	19.17	4.72	18.7%	5.6%	83.4%	60.8
Pfizer	Pharmaceuticals	1106.7	14.4	2.8	1.5%	0.0	349.09	11.28	23.8%	11.4%	13.2%	70.8
SKF India	Bearings	550.0	16.6	3.4	1.3%	0.0	100.97	10.41	21.7%	15.7%	22.2%	53.6
SML ISUZU	Automobiles	385.0	15.3	2.6	2.1%	0.4	59.01	7.29	22.6%	40.2%	51.1%	55.0
Timken India	Bearings	171.0	22.0	2.9	0.0%	0.0	49.63	13.51	47.4%	32.8%	43.8%	80.0
VST Inds.	Cigarettes	1088.4	18.6	6.4	4.1%	0.0	45.70	10.01	10.0%	62.5%	61.3%	32.2
WABCO India	Auto Ancillaries	1180.0	17.6	5.8	0.4%	0.0	107.89	10.77	17.8%	18.5%	24.3%	75.0
Wheels India	Auto Ancillaries	273.8	11.3	1.2	2.4%	1.5	-183.15	3.91	19.2%	32.1%	178.7%	35.9
Wyeth	Pharmaceuticals	842.6	11.5	5.0	2.6%	0.0	153.40	8.44	28.8%	30.8%	34.0%	51.1

Consolidated numbers provided wherever applicable, P/E, P/BV, Div Yield, D/E and Adj BV are based on latest full year numbers. (Database **Source:** Capitaline)
*= raised to 51.77% on November 29, 2011

The following table displays the changes in shareholding pattern in the shortlisted MNC companies since Mar 2011:

(%)	Sep-11				Jun-11				Mar-11			
Company Name	FII	DII	For. Prom	Tot. Prom	FII	DII	For. Prom	Tot. Prom	FII	DII	For. Prom	Tot. Prom
Agro Tech Foods.	3.3	8.5	48.1	48.1	3.2	7.9	48.1	48.1	3.7	6.6	48.1	48.1
Akzo Nobel	2.5	18.0	56.4	56.4	1.8	18.3	56.4	56.4	1.6	18.4	56.4	56.4
Areva T&D	1.3	13.6	73.4	73.4	1.3	13.7	73.4	73.4	1.3	13.3	73.4	73.4
Bayer Crop Sci.	4.8	10.5	69.5	71.1	4.4	8.5	69.5	71.1	3.6	8.8	69.5	71.1
Bosch	5.8	13.4	71.2	71.2	5.7	13.5	71.2	71.2	5.3	14.0	71.2	71.2
Castrol India	7.6	7.1	71.0	71.0	7.4	6.9	71.0	71.0	7.3	6.9	71.0	71.0
Clariant Chemical	2.5	8.2	63.4	63.4	1.3	6.9	63.4	63.4	1.4	6.3	63.4	63.4
Disa India	0.1	0.0	74.3	74.3	0.1	0.0	74.3	74.3	0.1	0.0	74.3	74.3

Eimco Elecon(I)	0.5	4.8	25.1	74.1	0.5	4.8	25.1	74.1	0.5	4.8	25.1	74.1
Goodricke Group	0.2	2.3	74.0	74.0	0.2	1.4	74.0	74.0	0.2	0.0	74.0	74.0
Grindwell Norton	2.5	8.2	51.3	58.6	2.3	7.4	51.3	58.6	2.1	6.9	51.3	58.6
India Nipp.Elec.	0.6	2.2	20.5	66.4	0.7	2.2	20.5	66.4	0.7	2.2	20.5	66.4
Ineos ABS (India	0.7	0.2	83.3	83.3	0.6	0.1	83.3	83.3	0.6	0.3	83.3	83.3
ITD Cem	0.5	2.6	69.6	69.6	0.5	3.1	69.6	69.6	0.5	3.4	69.6	69.6
Kansai Nerolac	6.4	4.7	69.3	69.3	6.3	4.7	69.3	69.3	6.0	5.0	69.3	69.3
Kennametal India	0.9	1.1	88.2	88.2	0.8	1.1	88.2	88.2	0.8	1.1	88.2	88.2
KSB Pumps	1.5	9.5	40.5	66.8	1.5	9.5	40.5	66.8	1.5	9.7	40.5	66.8
Paper Products	3.1	5.4	60.8	63.7	2.7	5.4	60.8	63.7	2.7	4.9	58.9	63.9
Pfizer	2.5	7.2	70.8	70.8	2.7	6.8	70.8	70.8	2.7	6.4	70.8	70.8
SKF India	14.4	16.9	53.6	53.6	14.5	16.4	53.6	53.6	14.4	16.1	53.6	53.6
SML ISUZU	17.6	9.7	55.0	55.0	17.7	9.7	55.0	55.0	17.7	9.7	55.0	55.0
Timken India	1.6	3.7	80.0	80.0	1.5	3.8	80.0	80.0	1.8	3.2	80.0	80.0
VST Inds.	3.1	12.0	32.2	32.2	1.2	11.8	32.2	32.2	1.3	11.9	32.2	32.2
WABCO India	2.3	10.5	75.0	75.0	2.2	10.5	75.0	75.0	2.1	10.8	75.0	75.0
Wheels India	0.3	0.6	35.9	85.7	0.3	0.6	35.9	85.7	0.3	0.6	35.9	85.7
Wyeth	4.7	13.7	51.1	51.1	4.8	14.4	51.1	51.1	4.3	14.5	51.1	51.1

(Database Source: Capitaline, HDFC Sec Research)

Note: The balance shareholding (100 minus the three categories listed above i.e. FII, DII and Total Promoters) represent public shareholding (including corporates). Higher/dispersed shareholding in public category could mean delisting could be more difficult.

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